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Investment Tax Credit--Section 38 Property--Buildings

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INVESTMENT TAX CREDIT – SECTION 38 PROPERTY – BUILDINGS

Arne Thirup[1]

The investment tax credit, designed to stimulate modernization and expansion of the nation's productive facilities,[2] is a major business tax incentive. Currently, the credit is ten percent of the qualified investment in new and used section 38 property. Limitations, carryover, and recapture rules are found with the basic provisions in sections 38 and 46 through 50 of the Internal Revenue Code (hereinafter referred to as the Code).[3]

Section 38 property is generally defined in section 48 (a) (1) of the Code and may be summarized to include depreciable property with an estimated useful life of three years or more which is:

1. Tangible personal property.
2. Other tangible property (*excluding buildings* and structural components thereof) if–
   A. used as an integral part of certain qualifying activities, or
   B. a storage or research facility used in connection with the same qualifying activities.
3. Elevators and escalators.[4]

The balance of section 48 contains exceptions and qualifications to the above general definition.[5] Distinguishing between buildings, which do not

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1. 508 F.2d 915 (9th Cir. 1974), *rev'g.* 59 T.C. 122 (1972).
2. CONF. REP. No. 2508, 87th Cong., 2d Sess. 3732 (1962).
3. INT. REV. CODE OF 1954, §§ 38, 46-50.
4. INT. REV. CODE OF 1954, § 48(a)(1) provides:

in general.–Except as provided in this subsection, the term "section 38 property" means–

(A) tangible personal property or

(B) other tangible property (not including a building and its structural components) but only if such property–

(i) is used as an integral part of manufacturing, production, or extraction or of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services, or

(ii) constitutes a research facility used in connection with any of the activities referred to in clause (i), or

(iii) constitutes a facility used in connection with any of the activities referred to in clause (i) for the bulk storage of fungible commodities (including commodities in a liquid or gaseous state), or

(C) elevators and escalators, but only if–

(i) the construction, reconstruction, or erection of the elevator or escalator is completed by the taxpayer after June 30, 1963, or

(ii) the elevator or escalator is acquired after June 30, 1963, and the original use of such elevator or escalator commences with the taxpayer and commences after such date.

Such term includes only property with respect to which depreciation (or amortization in lieu of depreciation) is allowable and having a useful life (determined as of the time such property is placed in service) of 3 years or more.

5. *See, e.g.,* INT. REV. CODE OF 1954, §§ 48(a)(3) (exclusion of property used to furnish permanent lodging), 48(a)(6) (certain livestock previously excluded now eligible for investment credit).

qualify for the investment credit, and other structures, which may qualify,[6] has proven to be one of the most troublesome problems encountered in applying the investment credit.

In *Arne Thirup*[7] the taxpayers claimed an investment credit for investments made in a greenhouse used in their business of growing and selling cut flowers. The greenhouse was a completely enclosed structure, 200 feet wide by 400 feet long. It was constructed of a wooden frame with fiberglass panels for a roof and walls. There was no floor; the flowers grew directly from the enclosed soil. The greenhouse was designed to supply a controlled environment and had built-in automatic temperature, humidity, watering, liquid fertilizing, and carbon dioxide systems. The fiberglass wall and roof panels were of a special type designed to diffuse the sunlight for better growing conditions. Also, windows in the roof opened and closed automatically to coordinate the external and internal temperature and humidity. Within the greenhouse, the taxpayers' employees performed such tasks as turning and fertilizing the soil, planting, pulling weeds, spraying chemicals, pruning, and harvesting. On occasion, some of the employees ate lunch and took work breaks inside the greenhouse, although no formal facilities were provided for this. It was estimated that approximately one-half of the total work hours were spent inside the greenhouse.

The Commissioner, conceding that the greenhouse was "other tangible property . . . used as an integral part of production" within section 48 (a) (1) (B) (i) of the Code, contended that the greenhouse was a building and therefore ineligible for the investment credit.[8] The United States Court of Appeals for the Ninth Circuit reversed the Tax Court and found the greenhouse to be section 38 property eligible for the investment credit.[9]

The "appearance test" (because it looks like a building, it must *ipso facto* be a building) was rejected by the court of appeals in *Thirup*.[10] This test is derived from legislative history[11] and finds additional support in the Treasury Regulations, which provide: "The term 'building' generally means any structure or edifice enclosing a space within its walls,

6. For a non-building structure to be eligible for the investment credit, it must be used as an *integral part* of manufacturing, production, or extraction, or as an *integral part* of furnishing transportation, communication, electrical energy, gas, water, or sewage disposal services by a person engaged in the business of furnishing the same. INT. REV. CODE OF 1954, § 48(a)(1)(B)(i) (emphasis added). A research or storage facility will qualify if it is used *in connection with* any of the foregoing activities. INT. REV. CODE OF 1954, § 48(a) (1) (B) (ii), (iii) (emphasis added). It is *possible* that a non-building structure could qualify as tangible personal property and not be subject to the question whether it is other tangible property used in a prescribed activity. *See* note 38 and accompanying text *infra*.

7. 508 F.2d 915 (9th Cir. 1974), *rev'g* 59 T.C. 122 (1972).

8. *Id.* at 917.

9. *Id.* at 920.

10. *Id.* at 918.

11. H.R. REP. No. 1447, 87th Cong., 2d Sess. A18 (1962); S. REP. No. 1881, 87th Cong., 2d Sess. 154 (1962).

and usually covered by a roof. . . ."[12] It is clear, however, that courts have generally concluded that certain structures, although resembling a building in appearance, are not to be considered such for purposes of defining section 38 property.[13] This is particularly true where the issue is whether the structure is a building or a storage facility, as opposed to a building versus a non-storage facility.[14] Illustrative is *Robert E. Catron*,[15] where the Tax Court analyzed the apparent contradiction between the broad definition of "building" in the Regulations and the eligibility of storage facilities as provided in section 48. It noted that a storage facility would not qualify if it were also a building and that it was difficult to imagine a storage facility that would not fit within the Regulations' definition of a building. The court refused to attribute to Congress such a "nugatory provision" and rejected the appearance test.[16] Similarly, the Commissioner has, when presented with the building versus storage facility issue, frequently refused to apply the appearance test.[17] The *Thirup* decision is significant because it is one of the first decisions rejecting the appearance test where the question is whether a structure is a building or a non-storage facility.[18]

A different test more frequently applied by the courts is a "function" or "use" test. Like the appearance test, the function test is derived from legislative history[19] and finds additional support in the Regulations.[20] This test limits the broad scope of the appearance test and states that a building is generally a structure with walls and a roof which also provides ". . . for example, . . . shelter or housing, or . . . working, office, parking, display, or sales space."[21] The function test was first developed in storage facility cases[22] and has only recently been applied in non-

12. Treas. Reg. § 1.48-1(e)(1) (1972).

13. *See, e.g.*, Brown-Forman Distillers Corp. v. United States, 499 F.2d 1263 (Ct. Cl. 1974); Brown & Williamson Tobacco Corp. v. United States, 491 F.2d 1258 (6th Cir. 1974); Melvin Satrum, 62 T.C. 413 (1974); Robert E. Catron, 50 T.C. 306 (1968). *But see* Sunnyside Nurseries, 59 T.C. 113 (1972). *Sunnyside Nurseries* was a companion case to *Thirup* in the Tax Court and was also appealed to the Ninth Circuit, but the appeal was dismissed for failure to prosecute.

14. *See, e.g.*, Brown-Forman Distillers Corp. v. United States, 499 F.2d 1263 (Ct. Cl. 1974) (warehouses for aging bourbon whiskey held storage facilities); Brown & Williamson Tobacco Corp. v. United States, 491 F.2d 1258 (6th Cir. 1974) (warehouses for aging tobacco held storage facilities).

15. 50 T.C. 306 (1968).

16. *Id.*

17. *See, e.g.*, Rev. Rul. 365, 1972-2 CUM. BULL. 8; Rev. Rul. 359, 1971-2 CUM. BULL. 62; Rev. Rul. 122, 1968-1 CUM. BULL. 10.

18. *See also* Melvin Satrum, 62 T.C. 413 (1974). The Commissioner has ignored the appearance test in at least one notable instance. *See* Rev. Rul. 209, 1968-1 CUM. BULL. 16 (appearance test ignored by the Commissioner with resultant classification of craneway structure as a building).

19. H.R. REP. No. 1447, 87th Cong., 2d Sess. A18 (1962); S. REP. No. 1881, 87th Cong., 2d Sess. 154 (1962).

20. Treas. Reg. § 1.48-1(e)(1) (1972).

21. *Id.*

22. *See* Brown-Forman Distillers Corp. v. United States, 499 F.2d 1263 (Ct. Cl. 1974); Brown & Williamson Tobacco Corp. v. United States, 491 F.2d 1258

storage facility cases.[23] Standards for applying the function test were initially announced in Revenue Ruling 66-89 (5) and provide that a structure is not a "building" if: (1) the structure cannot be reasonably adapted to other uses, and (2) the structure provides only storage space, but not work space.[24]

The inquiry whether the structure is reasonably adaptable to alternative uses focuses on the economic and physical practicability of conversion. The cost of converting the structure to an alternative use is a factor only recently mentioned in the cases and, standing alone, may not be very persuasive.[25] A showing by the taxpayer that the structure was specially designed to accomplish a particular qualifying activity alone may be enough to satisfy this standard.[26] Where, however, the structure has not been used exclusively for that activity or is available for multiple uses, then, notwithstanding a showing of special design, the structure may not qualify as section 38 property.[27] In *Central Citrus Company*[28] "sweet rooms" were used solely for storing fruit in a controlled atmosphere. Because of the special design and equipment systems inolved, the Tax Court held that these structures were not reasonably adaptable to alternative uses. In *Palmer Olson*[29] quonset-type structures were specially designed for grain storage. One of the structures had been used by the taxpayer as a machine shed and the others were used for grain storage only about ninety percent of the year. The Tax Court concluded that these structures were available and adaptable for alternative uses and consequently not eligible section 38 property.

The work aspect of the function test states that a structure may qualify as a storage facility if the only human activity performed therein is activity incidental to the storage function, and if the structure does not provide general work space.[30] In applying the work aspect portion of the

(6th Cir. 1974); Central Citrus Co., 58 T.C. 365 (1972); Palmer Olson, 29 T.C. Mem. 1367 (1970); Robert E. Catron, 50 T.C. 306 (1968).

23. *See* Arne Thirup, 508 F.2d 915 (9th Cir. 1974), *rev'g* 59 T.C. 122 (1972); Melvin Satrum, 62 T.C. 413 (1974).

24. Rev. Rul. 89, 1966-1 CUM. BULL. 7, *modified in other respects,* Rev. Rul. 222, 1972-1 CUM. BULL. 17.

25. *See* Brown & Williamson Tobacco Corp. v. United States, 491 F.2d 1258 (6th Cir. 1974); Melvin Satrum, 62 T.C. 413 (1974); Arne Thirup, 59 T.C. 122 (1972), *rev'd,* 508 F.2d 915 (9th Cir. 1974).

26. *See, e.g.,* Central Citrus Co., 58 T.C. 365 (1972); Adolph Coors Co., 27 T.C. Mem. 1351 (1968); Robert E. Catron, 50 T.C. 306 (1968). *See also* Melvin Satrum, 62 T.C. 413 (1974) (a non-storage facility case).

27. *See* Palmer Olson, 29 T.C. Mem. 1367 (1970); *cf.* Brown & Williamson Tobacco Corp. v. United States, 491 F.2d 1258 (6th Cir. 1974).

28. 58 T.C. 365 (1972).

29. 29 T.C. Mem. 1367 (1970).

30. Brown-Forman Distillers Corp. v. United States, 499 F.2d 1263 (Ct. Cl. 1974); Robert E. Catron, 50 T.C. 306 (1968); *see* Brown & Williamson Tobacco Corp. v. United States, 491 F.2d 1258 (6th Cir. 1974); William K. Coors, 60 T.C. 368 (1973).

To qualify for the investment credit, a storage facility must be used for the

function test, the Tax Court has been inclined to characterize as a "building" structures in which a "substantial number of [people are] frequently and regularly occupied."[31] *Thirup,* however, joins the other appellate court decisions on this issue and makes it clear that it is the nature of the work activity, rather than the amount of work, that is determinative.[32] The policy in tolerating work activity incidental to the storage function—*e.g.,* moving a product in and out of the storage facility, is consistent with section 48, for to do otherwise would disqualify most storage facilities.[33]

Thirup extended the function test to non-storage facilities[34] and may have confused the otherwise consistent development of a building's definition. The function test, based on sound policy, was developed to distinguish between a building and a storage facility. Application of this test in non-storage facility cases seems unwarranted in light of clear legislative history contemplating a broad definition of "building." This is not to say that the ultimate decision in *Thirup* was erroneous, only that the rationale was faulty.

The Regulations provide two express exceptions to the definition of a building,[35] either of which was potentially applicable in *Thirup.* The term "building" does not include a structure which is essentially an item of machinery or equipment.[36] Brick kilns[37] and refrigerator-freezer structures[38] would be included under this exception.

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bulk storage of fungible commodities. INT. REV. CODE OF 1954, § 48(a)(1)(B)(iii). *See also* Treas. Reg. § 1.48-1(e)(5)(ii) (1972).

31. Sunnyside Nurseries, 59 T.C. 113, 122 (1972). *See also* Melvin Satrum, 62 T.C. 413 (1974); Arne Thirup, 59 T.C. 122 (1972), *rev'd,* 508 F.2d 915 (9th Cir. 1974).

32. 508 F.2d 915 (9th Cir. 1974), *rev'g* 59 T.C. 122 (1972). The *Thirup* court stated:

> We find the distinction based on the *amount* of human activity unpersuasive. The proper inquiry, which goes to the *nature* of the employee activity inside the structure, is "whether the structures provide working space for the employees that is more than merely incidental to the principal function or use of the structure."

Id. at 919. (emphasis in original—citations omitted). *See also* Brown-Forman Distillers Corp. v. United States, 499 F.2d 1263 (Ct. Cl. 1974); Brown & Williamson Tobacco Corp. v. United States, 491 F.2d 1258 (6th Cir. 1974).

33. *See* Robert E. Catron, 50 T.C. 306 (1968) (citing Rev. Rul. 68-133 where the Commissioner held moving potatoes in and out of storage did not disqualify the storage facility).

34. *See also* Melvin Satrum, 62 T.C. 413 (1974) (applying the function test to an egg producing facility).

35. Treas. Reg. § 1.48-1(e)(1)(i), (ii) (1972).

36. Treas. Reg. § 1.48-1(e)(1)(i) (1972).

37. Treas. Reg. § 1.48-1(e)(1) (1972). *See also* Rev. Rul. 557, 1969-2 CUM. BULL. 3 (wood drying kilns).

38. Rev. Rul. 489, 1971-2 CUM. BULL. 64. If an item of property is within this exception, it might properly be characterized as tangible personal property, and as such it would qualify as section 38 property without regard to a qualifying activity. *Compare* INT. REV. CODE OF 1954, § 48(a)(1)(A) *with* INT. REV. CODE OF 1954, § 48(a)(1)(B)(i), (ii), (iii). *See also* note 6 *supra.* However, the Regulations provide that tangible personal property does not include "inherently permanent" structures. *See* Treas. Reg. § 1.48-1(c) (1972). The appropriate definitional subpart

The second exception is for "special purpose structures." The Regulations state that if the structure houses equipment used as an integral part of a qualifying activity and if the use of the structure is so closely related to the use of that equipment that the structure can be expected to be replaced contemporaneously with the equipment, then the structure is excepted from the definition of a building and is eligible for the investment credit.[39] Factors enumerated in the Regulations indicating that a structure is within this exception are: (1) that the structure is specially designed to provide for the stress and other demands of the equipment housed therein, and (2) that the structure could not be economically used for other purposes.[40]

There is little case law elaborating either exception.[41] One interesting example of a "special purpose structure" is a 1966 Revenue Ruling where the Commissioner ruled that a unitary hog raising facility did not qualify for the investment credit.[42] An elliptical steel structure housed automated systems for the farrowing, feeding, and raising of hogs. The equipment housed within the structure included automatic feeders, waterers, and heat system, special airflow units, slatted flooring for sewage disposal, space heaters for farrowing, and movable pens and partitions. The Commissioner ruled that special design alone was not controlling to except the structure from classification as a building.

However, in 1971, while considering statutory language to limit storage facilities to those storing fungible goods in bulk, the Senate Finance Committee Report clarified the fact that the term building is not intended to include "special purpose structures." The Report used as an example of such a structure a unitary system for raising hogs and specifically concluded that such a structure would be eligible for the investment credit.[43] Considering the external shell of the structure as merely a way of tying together the equipment systems, the Senate report stated: "There is no other practical use for the structure and it can . . . be expected to be used only so long as the equipment it houses is used."[44]

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of section 48 for an item of property which is "inherently permanent," yet within the equipment or machinery exception to a building, is unclear. *But cf.* Rev. Rul. 489, 1971-2 CUM. BULL. 64; Rev. Rul. 557, 1969-2 CUM. BULL. 3.

39. Treas. Reg. § 1.48-1(e)(1)(ii) (1972). The Regulations previously provided that the structure *must* be replaced contemporaneously with the equipment. Treas. Reg. § 1.48-1(e)(1)(ii) (1964).

40. Treas. Reg. § 1.48-1(e)(1)(ii) (1972).

41. *See* Walton Mills, Inc., 31 T.C. Mem. 75 (1972); Adolph Coors Co. 27 T.C. Mem. 1351 (1968). The Commissioner has generally applied a narrow interpretation of these exceptions. *See, e.g.*, Rev. Rul. 281, 1973-2 CUM. BULL. 8; Rev. Rul. 398, 1972-2 CUM. BULL. 9. For examples of structures falling within the first exception, see Rev. Rul. 489, 1971-2 CUM. BULL. 64; Rev. Rul. 557, 1969-2 CUM. BULL. 3. For examples of structures within the second exception, see Rev. Rul. 223, 1971-1 CUM. BULL. 117; Rev. Rul. 104, 1971-1 CUM. BULL. 5; Rev. Rul. 412, 1969-2 CUM. BULL. 2.

42. Rev. Rul. 329, 1966-2 CUM. BULL. 16.

43. S. REP. No. 437, 92d Cong., 1st Sess. 29-30 (1971).

44. *Id.*

Similarly, the greenhouse in *Thirup* could have been analogized to the hog raising facility in the Senate report. The greenhouse contained environmental control systems used as an integral part of a qualifying activity and was so closely related to the use of that equipment that it might be expected to be used only so long as that equipment was used. No doubt the greenhouse was specially designed to accommodate the equipment systems and further factual inquiry would probably have led to the conclusion that it had no economically practical alternative use.

In summary, it is essential to keep in mind that there are several separate and distinct approaches available to avoid the "building" label: (1) the two exceptions to the Regulation's definition of a building—classification as machinery or equipment, and "special purpose structures;" and (2) the statutory exclusion for storage facilities.[45] In certain respects, the standards for applying these different approaches are similar. For example, the factual considerations under the Regulation's exception for "special purpose structures" closely approximate those of the alternative use aspect of the function test used in storage facility cases.[46] Confusion may easily result from this similarity unless careful examination is made of the context in which such phrases as "special design" and "alternative use" are employed. Additionally, in attempting to avoid the "building" label, a critical distinction must be observed. The work aspect of the function test is a relevant consideration *only* in storage facility cases and should not be a factor in a non-storage facility case, as it was in *Thirup*. The legislative intent will be more accurately carried out if this distinction is noted and respected.[47]

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45. A literal reading of section 48(a)(1)(B) indicates that only those storage facilities which are not also buildings are eligible section 38 property. However, as noted, the courts have contracted the otherwise broad definition of "building" where it conflicts with the statutory provision making certain storage facilities eligible for the investment credit. *See* text accompanying note 16 *supra*.

46. *Compare* text accompanying notes 39-40 *supra with* text accompanying notes 25-29 *supra*.

47. A word of caution is appropriate. The scope of this note is confined to particular aspects of the definition of the term "building" as that term is used in defining section 38 property. The complex definitional scheme of section 38 property is thoroughly integrated, with individual definitional subparts interdependent upon others. As a consequence, expansion of an individual definitional subpart will result in contraction of others. Before relying on a particular aspect of this scheme, careful examination of the whole is necessary.